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SENATE BILL 3580
76th Congress

Statement by

THE AMERICAN INSTITUTE OF ACCOUNTANTS

Before
Subcommittee, Senate Committee on
Banking and Currency

STATEMENT ON SENATE BILL 3580 IN THE 76TH CONGRESS TO PROVIDE FOR THE REGISTRATION AND REGULATION OF INVESTMENT COMPANIES AND INVESTMENT ADVISERS

Statement by American Institute of Accountants

This statement, which deals only with Section 32 (c) (1) of Senate Bill 3580, has been prepared by a special committee of the American Institute of Accountants. The chairman of this special committee is the president of the Institute, and its members include a vice president, two members of the executive committee, the chairman of the special committee on coöperation with Securities and Exchange Commission, and a member of the committee on auditing procedure.

The American Institute of Accountants is the national professional organization of certified public accountants in the United States, with a membership of 5,316, including the great majority of those who act as auditors for companies registered with the S.E.C. The Institute's activities are similar to those of other professional organizations, including the maintenance and enforcement of rules of professional conduct, preparation of professional examinations, publication of technical and professional material, maintenance of an accounting library and a research department, etc. The Institute has coöperated in various ways with many governmental and private bodies, including the Securities and Exchange Commission, which consulted the Institute in the development of accounting rules and regulations under the Securities Act and the Securities Exchange Act. These matters are mentioned in order to inform the committee who we are, and to indicate that we are generally familiar with the type of problems with which Senate Bill 3580 deals.

A good many sections of the bill relate to accounting and

auditing. While we are, naturally, keenly interested in the bill as a whole, we believe it proper to restrict our recommendations to one provision of the bill, directly affecting professional certified public accountants as such, which we consider important enough to justify this appearance before your committee.

It Is Recommended that Section 32(c)(1) of the Bill Be Deleted

We earnestly recommend that Section 32 (c) (1) of Senate Bill 3580 be deleted. This section provides that:

"The Commission is authorized, by rules and regulations or order in the public interest or for the protection of investors—

(1) to prescribe the minimum scope of and procedures to be followed in any audit of a registered investment company;"

We object to this provision on the ground that it would permit assumption by a governmental administrative agency of a responsibility which should be assumed by professional practitioners; i.e., determination of how extensive an investigation an independent auditor should make, and the manner in which he should make it, before signing his name to his own professional opinion regarding the financial position and the results of operations of the company under audit.

It is submitted that

(1) Such a responsibility could not be successfully assumed by a governmental administrative agency;

(2) An attempt to fix minimum standards would tend to lower rather than to raise the standards of auditing practice;

(3) It would be a new departure in federal legislation to provide for supervision by government agents of the details of the work of professional practitioners;

(4) It would be an unwarranted and unnecessary invasion of a field of professional practice.

Scope of Audit Is a Matter of Sound Judgment, Differing in Each Case, and Cannot Satisfactorily Be Prescribed by Regulations

It may clarify our suggestion to interpolate at this point a brief statement of the status of the certified public accountant and the nature of his work. There are, at present, more than 19,000 certified public accountants in the United States. The certificate of certified public accountant is issued by state administrative boards, created by law, to candidates who have met prescribed educational and experience requirements and have passed written examinations in auditing, commercial law, accounting theory and practice and, in some cases, other subjects. Certificates may be revoked for malpractice or unprofessional conduct.

The certified public accountant in professional public practice is an independent practitioner. He is not employed on a salary basis by the concerns which he audits but is retained by them as clients, on a fee basis. His position is different from that of the bookkeeper, internal auditor or controller permanently employed by a corporation. The position of the independent certified public accountant is comparable with that of the practising attorney, engineer, or physician performing services in particular cases for clients or patients who do not direct the professional man as to methods but look to him for results.

The rapid development of the profession of the certified public accountant is largely a result of the public demand for a disinterested, independent review and check by competent technicians of the accounting records and the accounting judgment of the management of corporate enterprises which make use of the savings of the public. The certified public accountant recognizes a heavy responsibility to all interested parties, including stockholders, potential investors, and creditors, who may be influenced by his professional opinion regarding the

financial position and the results of operations of the company concerned, as expressed in his report or certificate as a result of his audit.

An audit is not a simple mechanical process. It is a highly technical and complex procedure of examining or testing accounting records and the evidence which supports them. Some book entries may be confirmed by inspection of cash, securities or other physical assets. Underlying evidence which may be called for to support other entries in the accounts may consist of such varying items as written confirmations of accounts with debtors or creditors, directors' minutes, contracts, vouchers, invoices, canceled checks, etc.

It is the duty of the auditor to satisfy himself that the accounts and the financial statements based on them fairly present the situation. He must use his own judgment as to the extent to which it is necessary to check individual records of transactions, and the manner in which they shall be checked, in order so to satisfy himself. Various factors—for example, the efficiency of the internal accounting or internal auditing of the company—may have a bearing on his judgment of the extent and nature of the examination which he must make in each individual case.

No two cases are exactly alike. Frequently the auditor finds it necessary to go further in some respects than is usual, and perhaps, in other respects, due to favorable factors, he may decide that it is unnecessary to do as much work as might be customary. He is responsible morally and legally for the opinion expressed in his report or certificate. He must decide for himself the amount and nature of the work he must do in order to justify the expression of his opinion.

If auditing were a simple mechanical process, the profession of the certified public accountant would not have developed so rapidly in numbers and in prestige. It is the need for skilled judgment, based on technical training and experience,

which has brought into existence the thousands of certified public accountants who are practising in this country today.

The minimum scope of and procedures to be followed in an audit cannot satisfactorily be laid down by rules and regulations as is provided in Section 32 (c) (1) of the bill. The auditor must use his judgment and discretion in determining the scope of the audit and the methods of procedure just as much as in formulating his final opinion on the balance-sheet and income statement which are the subject of his report.

The Government Should Not Assume the Responsibility Inherent in Section 32 (c) (1)

No government agency nor any other body could set up practicable rules or regulations prescribing the scope (extent) of audit and the procedure (how to do it) to be followed by auditors in all cases. If that were possible auditing would be a routine procedure which could be left to clerks. No one can foresee the circumstances which the auditor will encounter in an individual case. The American Institute of Accountants has had considerable experience with this problem. It published in 1917, at the request of the Federal Trade Commission, an outline of points to be covered in typical examinations, under the title, "Approved Methods for the Preparation of Balance-Sheet Statements," which was later approved by the Federal Reserve Board. This outline was revised in 1929, under the title "Verification of Financial Statements" and again in 1936, under the title "Examination of Financial Statements by Independent Public Accountants." The several revisions indicate growth and progress, as well as the impossibility of rigid standardization. It has been necessary in each bulletin to make clear that in individual cases an auditor may be justified in departing and may find it necessary to depart from these outlines, and may frequently find it necessary to go further than the outline suggests.

It has been frequently announced that the policy of the Congress in enacting the Securities Act was only to provide for full disclosure of material facts in the affairs of a company offering its securities for sale, in order that the prospective investor might have a fair basis for a decision as to whether or not to purchase the securities. The Securities and Exchange Commission requires that every prospectus issued under the 1933 Act bear the words, "These Securities have not been approved or disapproved by the Securities and Exchange Commission" and "It is a criminal offense to represent that the Commission has approved these securities or has made any finding that the statements in this prospectus or in the registration statement are correct." In other words, the Government says it takes no responsibility for the results of the investor's decision. It seems to us that there is an analogy between this problem and the problem raised by Section 32 (c) (1) of the Senate Bill 3580.

If a government agency prescribed "the minimum scope of and procedures to be followed in any audit of" an investment company it could hardly escape responsibility for the results of an audit conducted in compliance with that prescription. It is possible that a competent auditor might comply exactly with rules of the Commission regarding minimum scope of audit and procedures to be followed, and yet fail to discover material facts of the utmost importance to investors. In such an event would the auditor be relieved of blame because he had meticulously followed the instructions of a government agency? Probably not, but the government agency could hardly escape a share of the blame in the minds of the investors whose interests had been adversely affected.

It is an ancient principle of law that a person whose conduct may be controlled and directed as to details of procedure is an employee, or servant, as distinguished from an independent contractor who may choose his own methods and who is held only for results. It is equally well established that there

is a definite liability for acts of an employee performed in the course of his employment. If the Commission were to prescribe the procedures to be followed by accountants in their audits, the independence of their relationship would be seriously impaired, and if they were to be treated like employees or servants the Commission could not escape a share of moral responsibility for any harm that might result from their acts.

It seems to us not in the interests of the Government itself to assume a share of a responsibility which is rightfully a private responsibility, resting on the shoulders of a professional practitioner.

The Danger of Lowered Auditing Standards

Prescription of a minimum scope of audit would not, on the face of it, prevent an auditor from undertaking additional steps beyond the required minimum; but experience shows that there is a tendency for minimum requirements to become, in fact, maximum requirements. It would be difficult for an auditor to persuade a client to agree to an examination more extensive than that required by the Securities and Exchange Commission. We believe that such a condition might result in a lowering of the standards of auditing practice and might dull the sense of personal responsibility which is now keenly felt by the independent certified public accountant.

Section 32 (c) (1) Is a New Departure in Federal Legislation

We know of no federal law providing for specification by a government body of the procedures that professional practitioners shall follow, the manner in which they shall follow them, the steps that they shall take in the performance of their professional work. Section 32 (c) (1) of Senate Bill 3580, which does provide for such dictation to professional certified public accountants, would be an innovation in federal legislation.

It would be manifestly absurd to engage an attorney to present a case, and then prescribe exactly what statutes and decisions he should study, what arguments he should include in his brief, and how he should present them in court. He must use his judgment, with due regard for his professional standing and integrity. It would be equally absurd to instruct an engineer just how to apply the techniques of his profession in the planning and supervision of the construction of a bridge, or to instruct a physician in treating a patient. It is no less futile to attempt to lay down a pattern in advance which all certified public accountants must follow in conducting independent audits.

It is a commonplace that responsibility should carry commensurate authority. Certified public accountants bear heavy responsibilities. They risk their professional reputations every time they sign a report. They are subject to civil liabilities under the common law and under the Securities Acts. They are entitled to determine for themselves, without outside interference, what steps they will take in forming the opinions in the expression of which they incur these risks.

The independent status of the professional certified public accountant is vitally important in the performance of his function. A principal reason for his engagement to conduct an audit is to secure an objective, disinterested review of the facts and the presentation of the company's affairs, which will fully disclose information of importance to all parties at interest. The independent auditor is "in the middle." He is a kind of umpire. It is his duty to reveal the truth as he sees it, not to present a report favorable to the wishes of management, of creditors, of a governmental regulatory agency, or of any other one group. If a governmental agency had power to prescribe the scope of his investigations and the procedures which he should follow, it would acquire control and influence over the accountant which might impair his objectivity. The

accountant might, to a degree at least, assume the status of an agent for the regulatory body.

A. A. Berle, Jr., now Assistant Secretary of State, in an address before an accounting society, ascribed great importance to this point. He said ". . . your profession . . . having freed itself from the chains of servitude to businessmen . . . may all too easily find itself merely the ciphering agency for virtually unreviewable bureaucrats. It took time to teach merchants that they could not give orders to accountants as to what their figures should show; and the profession must never drop to the point where its members are in demand primarily because their opinions will change whenever a subexaminer, for reasons not put on the record, wishes a different arrangement of figures."

Section 32 (c) (1) Would Be an Unwarranted and Unnecessary Invasion of a Field of Professional Practice

Certified public accountants have achieved recognition as a profession in statutes, in the courts, and in the public mind. They have built strong state and national professional organizations; they have developed technical standards of practice, have maintained and enforced rules of professional conduct, and have exercised disciplinary authority over their members. This development has been gradual over the years and is continuing. They welcome the opportunity to coöperate with the Securities and Exchange Commission and other private and governmental agencies in further improvement of accounting and auditing and corporate financial reporting.

It is offensive to the members of this profession to suggest that the work of developing its technical and professional standards should be taken from the hands of the profession itself and be assumed by a department of the Federal Government.

The effect of Section 32 (c) (1), if it were administered under the widest possible interpretation, would be to make the Securities and Exchange Commission practically a partner of the accountant in every audit engagement undertaken pursuant to the terms of Senate Bill 3580—a situation inconsistent with the basic concept of the practice of any profession.

If the sponsors of the bill should argue that there is no intention of applying the provisions of Section 32 (c) (1) in any such extreme manner; that the Securities and Exchange Commission would administer it in a reasonable way with due respect for the considerations we have advanced, the reply must be that it is no defense of bad law to say that it will be well administered. We feel justified, therefore, in asking for the elimination of this objectionable provision from the bill itself.

Any effort to prescribe by rules and regulations the minimum scope of audit and procedure to be followed in all cases is foredoomed to failure, since every case is different from every other one. Mandate can never successfully be substituted for professional judgment.

Respectfully submitted for

THE AMERICAN INSTITUTE OF ACCOUNTANTS

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